


Memorandum

*Flex your power!
Be energy efficient!*

To: R. GREGG ALBRIGHT
Deputy Director
Planning & Modal Programs

Date: February 7, 2008

File No.: P1130-0774

From: MARYANN CAMPBELL-SMITH 
Chief, External Audits
Audits and Investigations

Subject: Incurred Cost Audit – California Northern Railroad

We have audited the costs claimed by and reimbursed to the California Northern Railroad (CNR) and its subcontractor, Quality Signal Construction (QSC), totaling \$4,799,730, for the work performed pursuant to Agreement No. 50R981 (Agreement) with the Department of Transportation (Department) to determine whether the costs are adequately supported and in compliance with the Agreement provisions and State and federal regulations. This audit is performed as a management service to the Department to assist in its fiduciary responsibility to State and federal regulatory agencies. The audit report, CNR's response, and QSC's response, are attached.

The report includes findings and recommendations for both the CNR and the QSC. Please provide our office with a Department action plan related to the audit recommendations within 90 days.

We thank you and your staff for their assistance provided during this audit. If you have any questions or need additional information, please call Luisa Ruvalcaba, Auditor, at (916) 323-7888 or Teresa Greisen, Audit Manager, at (916) 323-7910.

Attachment(s)

c: Brenda Bryant, Federal Highway Administration
Don Seil, General Manager, California Northern Railroad
John Mollart, Owner, Quality Signal Construction (QSC Audit Report only)
Bill Bronte, Division of Rail
Steve Cates, Division of Rail
Clark Paulsen, Division of Accounting
Terry Zanchi, Division of Accounting

P1130-0774
Incurred Cost Audit California Northern Railroad
February 2008

**Audits and Investigations
California Department of Transportation**

REPORT CONTENTS

AUDIT REPORT – California Northern Railroad	<u>Page</u>
Summary	1
Background	2
Conclusion	2
 FINDINGS AND RECOMMENDATIONS	
1. Inadequate Subcontract Management	4
2. Inadequate Timekeeping System	6
 ATTACHMENTS	
I. Response of California Northern Railroad	
II. Audit Report of Quality Signal Construction – subcontractor to California Northern Railroad	

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

SUMMARY

We have audited the costs claimed by the California Northern Railroad (CNR), totaling \$4,799,730, for the work performed pursuant to Agreement No. 50R981 (Agreement) with the Department of Transportation (Department). The audit was performed to determine whether costs are adequately supported and in compliance with the Agreement provisions and State and federal regulations. This audit is performed as a management service to the Department to assist in its fiduciary responsibility to State and federal regulatory agencies.

CNR is responsible for the claimed costs, compliance with Agreement provisions and State and federal regulations, and the adequacy of its financial management system to accumulate and segregate reasonable, allocable, and allowable costs.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit was less in scope than an audit performed for the purpose of expressing an opinion on the financial statements of CNR. Therefore, we did not audit and are not expressing an opinion on CNR's financial statements.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records selected. An audit also includes assessing the accounting principles used and significant estimates made by CNR, as well as evaluating the overall presentation.

The scope of the audit was limited to financial and compliance activities related to the above-referenced Agreement. Our audit of CNR's financial management system was limited to interviews of CNR staff necessary to obtaining an understanding of CNR's accounting and internal control systems and did not include detailed tests of transactions of CNR's accounting records as CNR subcontracted the work to Quality Signal Construction (QSC). The audit consisted of an evaluation of compliance with 23 Code of Federal Regulations (CFR) 140 and 646 for the reimbursement of costs totaling \$4,799,730, during the period February 18, 2002, (date of Notice to Proceed), through December 31, 2004. Our field work was completed on August 31, 2006, and transactions occurring subsequent to this date were not tested and, accordingly, our conclusion does not pertain to costs or credits arising after this date.

CNR contracted with QSC, a maintenance subcontractor, to perform work specified in the Department's Agreement with CNR. Given that QCR was reimbursed \$4,610,000 of CNR's claimed costs of \$4,799,730, an incurred cost audit of QSC was performed. The results of our audit of QSC are detailed in Attachment II to this report.

Due to inherent limitations in any financial management system, misstatements caused by error or fraud may occur and not be detected. Also, projections of any audit of the financial management system to future periods are subject to the risk that the financial management

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

system may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our findings and recommendations take into consideration CNR's response dated November 12, 2007, to our June 28, 2007 draft report. Our findings and recommendations, CNR's response, and our analysis of the response are set forth in the Findings and Recommendations to this report. A copy of CNR's full response is included as Attachment I.

BACKGROUND

On February 19, 2002, the Department entered into an Agreement with CNR for the elimination of hazards at 14 Railroad-Highway crossings in the City of Woodland. Subsequently, CNR contracted with subcontractor, QSC, to perform the work.

The Agreement between the Department and CNR required CNR to perform the work on a force account basis, whether the work was performed by CNR or a subcontractor. CNR failed to contractually place that requirement on QSC who bid the work on what appears to be a lump sum method of payment.

The Department's Division of Rail (Rail) requested that Audits and Investigations (A&I) perform an incurred cost audit of the Agreement with CNR. A&I began the incurred cost audit of CNR in August 2004. Since the majority of the costs reimbursed to CNR were incurred by QSC it was determined that an incurred cost audit of QSC was necessary. On September 22, 2004, a meeting was held between CNR, QSC, Rail and A&I to discuss the incurred cost audit of CNR and QSC. It was disclosed that QSC did not maintain an accounting system to substantiate billings on a force account basis. QSC agreed to undergo the audit but informed A&I that they needed time to compile their accounting records. Over the course of the audit, QSC attempted to substantiate the claimed costs and requested numerous extensions of time to locate records. The completion of the audit was delayed due to granting QSC additional time.

CONCLUSION

Based on our audit, costs claimed, totaling \$4,799,730, were not adequately supported and in compliance with the Agreement provisions and State and federal regulations. CNR did not properly subcontract for the work required under the Department's Agreement and did not maintain an adequate timekeeping system. As a result, we recommend CNR reimburse the Department \$4,799,730, which represents the amount the Department paid to CNR under the Agreement. For detailed findings and recommendations see Findings and Recommendations to this report.

This report is intended for the information of the Department, the Federal Highway Administration, the California Transportation Commission, and CNR. However, this report is a matter of public record and its distribution is not limited.

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

If you have any questions, please contact Luisa Ruvalcaba, Auditor, at (916) 323-7888, or Teresa Greisen, Audit Manager, at (916) 323-7910.



MARYANN CAMPBELL-SMITH
Chief, External Audits

Attachments

Audit Team

Teresa Greisen, Audit Manager
Zilan Chen, Audit Supervisor
Luisa Ruvalcaba, Auditor

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

FINDINGS AND RECOMMENDATIONS

Finding 1 – Inadequate Subcontract Management

Based upon our audit, California Northern Railroad (CNR) failed to properly subcontract for the work required under the Department of Transportation's (Department) Agreement. In addition, CNR failed to ensure that its subcontractor, Quality Signal Construction (QSC), maintained adequate accounting records that documented that the costs incurred were properly attributable to the Agreement project. As a result, CNR could not ensure that costs charged to the Department were properly attributable to the Agreement project.

Specifically, our audit noted:

- The Department's Agreement with CNR was for the installation of grade-crossing safety devices. CNR had QSC perform the Agreement work without entering into a contract with QSC, specifically for the installation of grade-crossing safety devices. Instead, CNR relied on an on-going contract with QSC for maintenance work that included the following provision:
New Construction. It is agreed that during the term of this Agreement QSC will solicit crossing upgrades and new installations on behalf of Railroad, and will layout, supply, and install crossings only after Railroad written approval of materials and design. Any projects that have been approved, whether funded or not, at the conclusion of this Agreement will be completed by QSC. Railroad retains the right to solicit bids from other contractors for construction of crossings if QSC fails to meet Railroad's standards of quality and safety, or CPUC standards for new construction.
- CNR did not contractually require QSC to maintain adequate accounting records that would document that the costs incurred were properly attributable to the project. (See Attachment II, QSC Finding 1 for additional information.)
- Pursuant to Agreement provisions between the Department and CNR, CNR, its contractors, and subcontractors, were required to have all records subject to audit and to retain the records for three years from the Department's receipt of the final bill. CNR failed to contractually pass on this requirement to QSC.
- CNR did not contractually specify the method of payment for the new construction. Although the estimate provided by QSC appears to indicate a lump sum method of payment, there is no contract provision stating such was the method.
- CNR was required by Agreement with the Department to perform the work on a force account basis, whether the work was done by CNR or a contractor. Force account basis means the direct performance of construction work with payment based on the actual cost of labor, equipment, and materials furnished and consideration for overhead and profit.

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

CNR did not contractually place such requirement on QSC. As a result, QSC did not maintain accounting records on a force account basis. (See Attachment II, QSC Finding 1 through 5 for additional information.)

- The method of payment is actual cost pursuant to the Agreement and, therefore, requires that reimbursement be requested after costs have been incurred and payments have been made. However, CNR failed to comply with the Agreement provision, as the first four invoices from QSC to CNR were billed by CNR to the Department prior to CNR paying QSC.
- The Agreement between the Department and CNR states that after purchase of material for the project, CNR and its contractors will bill for 80% of the total estimated cost of the material listed on the detailed estimate attached to the Agreement. Pursuant to an analysis of the material claimed, CNR billed the Department \$1,540,000 on an invoice approved for payment on February 28, 2002. The \$1,540,000 represented 80% of the total estimated costs of materials. However, pursuant to a listing of the materials claimed by QSC, only \$114,709 (7%) in vendor invoices were purchased and dated prior to February 28, 2002. Therefore, CNR billed for 80% of the materials when only 7% could be supported as having been purchased. In addition, the \$1,540,000 claimed by CNR was not supported by vendor invoices until January 7, 2003. Moreover, CNR also failed to contractually pass on this material purchase requirement to QSC.

23 CFR 1.646.216(f)(1)(iv) allows a railroad to enter into a contract for construction work with a contractor if there is an existing, continuing contract in place and if the costs are reasonable. However, 23 CFR 140.1 states, in part, that to be eligible, the costs must be properly attributable to the project.

Recommendation

We recommend that total claimed costs of \$4,799,730 by CNR be disallowed. CNR should reimburse the Department \$4,491,282, which is the amount the Department reimbursed CNR. In addition, CNR should implement procedures to ensure compliance with State and federal regulations, as well as ensure subcontracts are properly managed.

CNR Response

CNR disagrees with the finding and recommendation. See Attachment I.

Auditor's Analysis of CNR Response

The Agreement under audit is between the Department and CNR; therefore, CNR is responsible for supporting the claimed costs. Additionally, CNR is responsible for ensuring all subcontracted work complies with all provisions, and state and federal regulations stipulated in the Department's Agreement including the following provisions:

...All records of the company, its contractors and subcontractors are subject to audit by representatives of the State and Federal Highway Administration and will be retained for a period of three years from State's reception of aforementioned final bill.

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

All work to be done hereunder by Company shall be done only by its employees or by contract, working under Railroad Labor Agreements and shall be done on a force account basis, the cost thereof to be paid to Company by State in the manner hereinafter set forth.

CNR has listed steps they plan to take in regards to present contracting practices. However, those steps were expected to have been in place before and during the course of the Agreement under audit.

With regards to the premature billing of 80% of the total estimated costs of material, A&I disagrees with CNR's interpretation of the Agreement. The Agreement includes a provision that states:

The State will reimburse the Company on the basis of actual cost...

Therefore, CNR is to be reimbursed for its actual costs incurred at the time of the billing. A&I's finding and recommendation stands as originally reported.

Finding 2 – Inadequate Timekeeping System

Based upon our audit, CNR does not have a timekeeping system that is adequate to accumulate and segregate reasonable, allocable, and allowable project costs. Specifically, CNR does not use timesheets for salaried employees and does not require hourly employees to identify labor hours to specific projects. As a result, CNR can not ensure that costs charged to the Department were properly attributable to the Agreement project.

23 CFR 140.904(b) Eligibility states: "To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, subpart B.
- (4) Properly attributable to the project."

Recommendation

We recommend CNR implement a timekeeping system that is adequate to accumulate and segregate reasonable, allocable, and allowable costs.

CNR Response

CNR agrees with the finding and recommendation. See Attachment I.

Auditor's Analysis of CNR Response

Based on the response it appears the finding was not understood. Each contractor is responsible to maintain a job cost system that is adequate to accumulate and segregate reasonable, allocable, and allowable project costs. CNR is responsible for substantiating its own costs attributable to the project. During the audit it came to the Auditor's attention that CNR, for its own employees, does not use timesheets for salaried employees and does not require hourly employees to identify

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

labor hours to specific projects. As a result, if CNR were to bill the Department direct labor costs attributable to its own employees such costs would not be allowable due to lack of substantiating timekeeping records.

Auditor's Analysis of Additional Comments from CNR

CNR requested QSC be provided additional time to reconstruct its accounting records. QSC has been attempting to reconstruct their accounting records since September 2004, when the first meeting between QSC and A&I took place. Several time extensions were granted to QSC during the audit but they were unable to provide sufficient and adequate supporting documentation.

The audit initially did treat the 14 crossings as one project. The only reason why time and materials were subsequently segregated by crossing was due to the lack of a job cost system. A job cost system would have segregated QSC's construction and maintenance jobs. Due to the lack of a job cost system, an attempt was made to isolate costs attributable to the crossings to provide some assurance that such costs were attributable to the Agreement and not to other work that QSC may have performed.

CNR's response states "CNR is informed, however, there was no crossover between QSC's maintenance employees and its construction employees. Thus, there could have been no improper use of funds in this respect". During the audit A&I attempted to review all documentation supporting this claim but QSC could not provide evidence to corroborate their testimonial claim.

ATTACHMENT I

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

Response of California Northern Railroad



November 12, 2007

Ms. Maryann Campbell-Smith
Chief, External Audits
Audits and Investigations
California Department of Transportation
1304 "O" Street, Suite 200
P. O. Box 942874 (MS2)
Sacramento, CA 94274-001

RE: Incurred Costs Audit-California Northern Railroad
File No. P1130-0774; Agreement No. 50R981
Project No. STPLR-5046(022)

Dear Ms. Campbell-Smith:

California Northern Railroad Company (CFNR) responds to the draft incurred costs audit of the work performed pursuant to Agreement No. 50R981 (Agreement) done by the California Department of Transportation (Department). Before preparing this response, CFNR investigated its contracting practices with the Department and with Quality Signal Control, Inc. (QSC) and the audit findings applicable to CFNR and QSC. Additionally, CFNR retained William Mazer of Accretive Solutions, Jacksonville, Florida. Mr. Mazer is a certified public accountant with much experience in auditing practices including audits involving the expenditure of Section 130 funds. Mr. Mazer's report to CFNR is attached. (Mazer Report). Mr. Mazer's report is adopted by CFNR as a portion of its response to the draft audit of the Department.

RESPONSE TO AUDIT FINDINGS APPLICABLE TO CFNR

The audit findings applicable to CFNR are: (1) CFNR did not properly subcontract the work ; and (2) CFNR did not maintain an adequate timekeeping system. Each of these findings is addressed below:

Response to the Audit Finding on the Contracting of the Work to QSC

For several years and over the course of many grade crossing improvement projects, CFNR, QSC and the Department engaged in practices deemed adequate by the Department and which were not the subject of any audit or complaint by the Department. There was no separate construction contract between CFNR and QSC. Rather, construction work was performed under the Maintenance Agreement between CFNR and QSC through the "New Construction" provision in that agreement. Nothing in the Agreement requires CFNR to separately and formally contract with its subcontractors for construction work. QSC understood it had obligations under the Agreement because it received a copy of the Agreement, which states "the Company, its contractors are subject to audit . . ." and elsewhere states ". . . shall be done on a force account basis . . ." QSC was thus on notice that it was responsible for the maintenance of adequate accounting records which could be subject to audit. CFNR had every reason to believe QSC was maintaining adequate accounting records. QSC submitted proposals for work which, in turn, were sent to the Department for incorporation in agreements for grade crossing improvement, work was performed pursuant to an agreement, the work was approved by the Department and invoices for the work were sent to and approved by the Department.

Ms. Maryann Campbell Smith

November 16, 2007

3

CFNR thus believed it and QSC were acting properly and in accordance with the Agreement and any guidelines established by the Department.

Despite this history, CFNR is willing to comply with the Department's present desires in respect to contracting practices. Specifically, CFNR will execute a separate construction contract with QSC or any other contractor which CFNR might employ to engage in construction of grade crossing improvements. The separate construction contract will:

- require QSC or any other contractor to maintain adequate accounting records.
- require the contractor's retention of accounting records for three years after receipt, by the Department, of the final bill for construction.
- specify the method of payment to the contractor.
- require the contractor to maintain accounting records on a force account basis.

Additionally, CFNR will agree to bill the Department only after costs are incurred and payment has been made to the contractor.

CFNR is troubled by the draft audit findings that it prematurely billed for 80% of the total estimated costs of material for the project. The agreement states "... after purchase of materials for the project, CFNR and its contractors will bill for eighty percent of the total estimated costs of the material listed on the detailed estimate attached to the agreement." In CFNR's view, it complied with this Agreement provision since it requires only that some materials be purchased before billing for 80% of the total

estimated cost of material. The Department's reading of this provision would require CFNR to advance very large sums of money for material purchases before it could invoice the Department for such purchases. This would create an undue financial burden on CFNR, which is a small railroad with limited financial resources. At the least, the contract provision at issue here is ambiguous and CFNR would like to engage in discussions with the Department as to its meaning.

Last, CFNR will put in place a formal and documented periodic review of any contractors accounting methods and procedures to insure they are in accordance with agreement provisions and adequate accounting records are maintained to insure costs are properly attributable to any project.

Response to Draft Audit Findings, No. 2-Inadequate Time Keeping System

CFNR's response to this finding is discussed above. Specifically, CFNR will require, by contract with QSC or any subcontractor, that the subcontractor maintain an adequate accounting system which will permit CFNR to segregate reasonable, allocable, and allowable project costs.

RESPONSE TO AUDIT FINDINGS APPLICABLE TO QSC

QSC is responsible for responding to the audit findings directed to it. To assist QSC and to hopefully resolve the Department's audit findings in respect to QSC, CFNR requested its consultant, Mr. Mazer, review the documents submitted by QSC to the Department during the audit, review QSC's accounting practices and procedures, conduct

a review of certain of QSC's accounting records at its corporate headquarters in Ft. Worth, Texas and meet with QSC corporate officers and retained certified public accountants. Mr. Mazer has done these things. His findings are covered in the Mazer Report. CFNR is informed that QSC, based on Mr. Mazer's recommendations, is presently engaged in the reconstruction of its accounting records to insure the costs charged to the Department were properly attributable to the Agreement's projects. CFNR is further informed the work to accomplish this is substantial and, even if multiple personnel are employed, the work will take at least 90 days to complete. While CFNR appreciates the Department's desire to resolve the issues raised by the audit, fairness requires QSC be given the necessary time to complete this work, given the magnitude of the financial consequences which the draft report would impose on QSC and CFNR.

OTHER COMMENTS RELEVANT TO THE AUDIT

Improvements to 14 crossings in the City of Woodland were covered by the agreement. Both CFNR and QSC always treated the work as one project, not 14 projects. CFNR and QSC also believed the Department treated the work as one project. The one project concept led to the lack of accounting records for time and perhaps materials which segregated time and materials by crossing. Because of the one project concept, CFNR and QSC do not believe it is reasonable for them to now attempt to segregate time and materials per crossing.

CFNR and QSC had a maintenance agreement in effect before the agreement was executed. This agreement provided QSC would maintain existing crossing warning

signals on CFNR's lines. The draft audit expresses some concern that funds for the project could have been utilized for maintenance of existing crossing signals systems rather than construction activities under the Agreement. CFNR is informed, however, there was no crossover between QSC's maintenance employees and its construction employees. Thus, there could have been no improper use of funds in this respect.

Summary

CFNR believes it has adequately addressed the Department's concerns about its contracting practices and the maintenance of appropriate accounting records. As noted above, CFNR believes fairness requires QSC be given an opportunity to reconstruct its accounting records to fully meet the findings in the draft audit report, and that this presentation be made in advance of the preparation of the final report. When the final report is issued, CFNR requests discussions with appropriate department employees in the hope of resolving all issues in a manner satisfactory to the Department.

Very truly yours,

California Northern Railroad Company

By: 
Donald Seif, President & General Manager

Accretive Solutions

Formerly CFO Services
We never lower the bar

Jacksonville, Florida, November 13, 2007

Donald Seil, General Manager
California Northern Railroad Company
401 N. East Street, Suite F
Woodland, California 95776

Dear Mr. Seil – Our report on the assessment of the audit findings related to CNR and QSC by CalTrans follows.

Project Scope – Accretive Solutions was engaged to assess the audit findings noted in the reports produced by the auditors for the State of California, Department of Transportation (CalTrans) to provide a more comprehensive understanding of the processes and procedures of the California Northern Railroad (CNR) and Quality Signal Construction (QSC) as they relate to the findings of CalTrans and determine what remedial actions should be taken on the part of CNR.

We performed various procedures as described in the following report, which were agreed to by CNR. The sufficiency of these procedures is solely the responsibility of CNR. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not conduct an audit or any other attestation service as ordinarily performed by a CPA, the objective of which would be the expression of an opinion. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Consequently, our role for this engagement is strictly as an advisor to management in a financial consulting capacity.

Information Provided to CalTrans' Auditors – From discussions with QSC, their representatives and CNR personnel and from the available information, CalTrans' auditors received from QSC a summary sheet without adequate back-up. Many of the references in the report are from this summary sheet. The limited back-up (e.g., time/equipment summary sheets, vendor invoices, etc.) that was provided didn't tie into the summary totals, which would have made it very hard to audit those numbers. QSC did provide some information, but it was in such a fashion to make the process of review tedious and complicated, which would have naturally raised the level of suspicion and skepticism on the part of the auditors. QSC is trying to remedy this with the clean-up of the Job Cost Ledger and the gathering of supporting documents. Also, QSC provided the auditors with cost summary sheets that identified direct labor, indirect labor and equipment used. These sheets were not original documents, but seemed to have been developed for use by the auditors.

Unclear Nature of the Project and Contract - The parties involved have different views on the nature of the project's contract. This is manifested by the wording of the contract (e.g., "force account basis", "lump sum"), billing practices by CNR and QSC, approval and payment practices by the state, interpretations by the auditors, etc. Some see this as a single contract for 14 road crossings, and some see it as 14 contracts bundled together in one document. This is clearly a legal determination beyond the scope of this engagement.

Audit Findings Applicable to CNR

The specific audit findings applicable to CNR are basically that CNR "... did not properly subcontract the work ... and did not maintain an adequate timekeeping system." The later issue is the essence of the former. That is, an adequate accounting system was supposed to be a part of the contract between CNR and QSC.

On the first point, there are several issues that should be considered. The first is that nothing in the contract requires CNR to formally contract with its subcontractors. The next issue is whether CNR believed QSC understood that it had some obligations under the contract. QSC did receive a copy of the contract which states "... the Company, its contractors and subcontractors are subject to audit ..." and elsewhere states "... shall be done on a force account basis ...", in which case QSC was on notice that they were responsible to maintain adequate records that at some point could be reviewed. The issue is that QSC as a contractor dealing with various state governments on other such matters was aware that a certain level of documentation was required to be maintained for review by funding authorities. CNR had every reason to expect that this would be done in the normal course of business. However, CNR had some responsibility to ensure that its subcontractors were performing as they knew they should have to perform (e.g., performing as intended, keep good accounting records, etc.). Likewise the state should have some method to determine that the invoices they approved and paid were in accordance with the guidelines in their contract. For the state to continuously pay invoices that showed no adherence to the contract guidelines, sets a precedent that submitting such invoices was acceptable. On this point, it is likely that the state has done this for a very long time with CNR and QSC along with other contractors.

CNR outsourced the entire project to QSC and its subcontractors, so as a practical consideration, a time keeping system for CNR makes no sense, as it would have been a duplication of QSC's system and efforts, and it would have been difficult for CNR to implement (i.e., capture of data and accounting classification) such a process over QSC's personnel.

What seems to have been the case is that all the parties felt they had an understanding of what their obligations were as well as everyone else's obligations and those were based on the contract to set the objectives for the project, and past practices to set the administrative and accounting guidelines and standards.

Also, Attachment "I" reiterates findings addressed above little ambiguous. It states "... after purchase of materials for the project, CNR and its contractors will bill for 80% of the total estimated cost of the material listed on the detailed estimate attached to the agreement". The first part of the contract language seems to indicate that at least some materials need to be purchased before billings can start. The second part seems to support this as it requires billing based on an estimate of total materials. That is, why would the contract require billings on an "estimate" if the actual totals were available? The answer is likely that it is a practice (i.e., mobilization costs) based on the reality that it is the state's responsibility for funding of the project. Also, see comments below under Finding -1.

Recommendation - CNR should ensure that all subcontractors are bound by the same contractual obligations that CNR is bound to, by executing contracts with the subcontractors that mirror the obligations of CNR. Also, CNR should put in place a formal and documented review of subcontractor's practices to ensure that such are in accordance with the stipulations in the contracts.

Audit Findings Applicable to QSC

Attachment A of the QSC Audit report has six findings and seems to be the most comprehensive of the several audit documents that they have circulated and effectively addresses all of the findings discussed in other documents. As such, I will address my comments to those findings described in Attachment A.

Finding 1 – Inadequate Financial Management Systems – This finding deals with four elements. The first three are references to finding 2, 4 and 5 and will be discussed below for each of the findings. The fourth element relates to charges incurred prior to the signing date or after the end date of the contract. CalTrans has identified about \$193,000 of such costs. I'm only able to identify about \$50,000 of such costs and those are all from before the contract was signed. There may be legitimate challenges to the costs incurred early in 2001 associated with Robert Luciano and GE training, which amount to about \$44,000. However regarding materials there is acceptance for this in the regulations, as 23 CFR 646.216 (e) states that "... cost for materials stockpiled at the project site or specifically purchased and delivered to the company for use on the project may be reimbursed on progress billings prior to the approval of the executed State-Railroad Agreement in accordance with 23 CFR 140.922(a) and § 646.218 of this part." Also, 23 CFR 646.218 (b) states that "Eligible preliminary engineering costs may include those incurred in selecting crossings to be improved, determining the type of improvement for each crossing, estimating the cost and preparing the required agreement", which indicates that certain engineering costs incurred prior to the FHWA authorization may be acceptable.

Regardless of the amounts before or after the contract period, the deciding factor will likely be the practices in place, the history of acceptance by CalTrans and the discussions and interactions taking place before or after. Any cost truly associated with the project, was likely incurred for the benefit and convenience of the City and State, and probably with their knowledge, as they were approving the invoices for payment.

As for recommendations for CNR, the recommendation noted above applicable to the CNR audit findings is all that CNR can put in place, as the responsibility to respond to CalTrans' findings here is QSC's.

Finding 2 – Unsupported Direct Labor Costs – One of the major concerns was the ability of QSC to support direct labor costs. From the construction and equipment time sheets provided to the state (note that these were the documents prepared for the state and not the original time sheets) we selected four days with about 35 individuals and requested supporting payroll information (payroll checks and payroll register for the period in question). This was done to determine the existence of people described on the sheets – there were no exceptions. I have determined that there are time sheets (not provided to CalTrans) which would have enough details to associate the individual with the project, but in some cases would not have enough detail to link the individual with a specific road crossing.

There are some practical reasons for not allocating costs at the individual road crossing level. For instance, much of the materials would be purchased in bulk for multiple locations and not a specific crossing. That is, the purchase of asphalt, concrete, wire, bungalows, etc. would be made in bulk during the project with the intent of simplicity and to reduce the cost due to volume purchases. Any allocation of such group costs becomes somewhat arbitrary. There are practical limitations of allocating labor costs. For instance if a worker was working on more than one project and is "bouncing" back and forth between the several projects (as was the case some times) it becomes somewhat of a problem to accurately capture that time by specific project and would likely result in some arbitrary allocations, which are of little value if this is a single project.

A concern does arise because time charged to the project by the two owners (i.e., Barney Bunnie and John Mollart) is not supported by time sheets. These charges were based on estimates of the time they worked on the job. This was confirmed by discussions with Mr. Bunnie. It is very likely that these two did spend time working directly on the project. However, assuming that these direct labor costs were somehow eliminated by CalTrans because they were considered invalid direct labor costs, they would then flow into the overhead calculations and be allocated based on the percentages applied to direct labor. The actual differences between the before and after calculations will likely be insignificant.

From the testing and the discussions it seems reasonable to assume that QSC will be able to develop acceptable support for labor costs applied to the project, as a whole. The exact amount of these costs are yet to be determined by QSC.

As for recommendations for CNR, the recommendation noted above applicable to the CNR audit findings is all that CNR can put in place, as the responsibility to respond to CalTrans' findings here is QSC's.

Finding 3 – Unsupported Fringe Benefit and Overhead Costs – QSC claims that the auditors calculated the overhead charges. Regardless of who did what, QSC is now in the process of calculating their overhead percentages in accordance with FAR31 (the guiding Federal Accounting Regulations for such). Without reviewing the work done by the auditors, there no way to understand their concerns about differences in balances between the summary totals and general ledger account balances.

QSC is now calculating the overheads and should be able to support their calculations.

As for recommendations for CNR, the recommendation noted above applicable to the CNR audit findings is all that CNR can put in place, as the responsibility to respond to CalTrans' findings here is QSC's.

Finding 4 – Unsupported Other Direct Costs – From the existing job cost ledger, I selected 15 very large invoices from subcontractors or for materials amounting to about \$1.2 million for testing. No exceptions were noted and it is reasonable to assume that these costs were associated with the project. Also, QSC is going through all costs to ensure that each transaction recorded in the JCL is supported by documentation.

A major concern of the CalTrans auditors is that some of the invoices didn't have anything to associate the charges with the project or a specific road crossing, nor were there contracts with subcontractors showing that such was to be performed. At this point in time, though very time consuming and a little complicated, it will be possible to prove that the cantilevers, asphalt, concrete, wire, bungalos, cross ties, etc. that were delivered to the Woodland area by local contractors were in fact used in the road crossings.

Another concern is that there were no contracts between QSC and it subcontractors, but only bids or estimating documents. Because of the lack of contracts the auditors come to the conclusion that the work was not done and all associated costs were not applicable to the project. I don't think the acid test is whether a contract was in existence, but rather are the costs claimed by QSC supportable and thus part of the project. Based on the limited testing that I did, I am comfortable that QSC will be able to support all the costs that they claim via the JCL.

The claim that \$142,000 in taxes and the \$90,000 of material handling costs are not allowable because the direct costs, which are the basis for calculating these costs, are not allowable is no more valid than their position on the direct costs. This will have to be resolved as part of the direct costs issues.

As for recommendations for CNR, the recommendation noted above applicable to the CNR audit findings is all that CNR can put in place, as the responsibility to respond to CalTrans' findings here is QSC's.

Finding 5 – Unsupported Equipment Costs – The reality is that QSC did not generate adequate documentation by day, which described the equipment that was used at each site. The only practical way seems to be to estimate what would have been necessary to do the job. QSC is supposed to develop those estimates. It is clear that equipment was used and reasonable estimates of the costs should be allowed. They have gathered documentation that supports the existence of the equipment, but not its actual usage at the site.

As for recommendations for CNR, the recommendation noted above applicable to the CNR audit findings is all that CNR can put in place, as the responsibility to respond to CalTrans' findings here is QSC's.

Finding 6 – Unsupportable Fee – This was an estimate of the profit that QSC would earn on the cost of the project. This will have to be worked out among the various parties when the other issues have been resolved.

Copies to:

Robert Jones
Regional Vice President
RailAmerica, Inc.
5300 Broken Sound Boulevard NW
Boca Raton, Florida 33487

Tracy Tejada
Accounting Supervisor
California Northern Railroad
129 Klamath Court
American Canyon, California 94589

Daniel Hershman
Vice President & Litigation Counsel
RailAmerica, Inc.
5300 Broken Sound Boulevard NW
Boca Raton, Florida 33487

Harold Tynes
Vice President and Controller
RailAmerica, Inc.
5300 Broken Sound Boulevard NW
Boca Raton, Florida 33487

B. Clyde Hutchinson
Attorney at Law
Lombardi, Loper & Conant
Lake Merritt Plaza
1999 Harrison St., Ste. 2600
Oakland, CA 94612

ATTACHMENT II

INCURRED COST AUDIT OF CALIFORNIA NORTHERN RAILROAD

**Incurred Cost Audit of Quality Signal Construction, a
Subcontractor to California Northern Railroad**

P1130-0774
Incurred Cost Audit Quality Signal Construction, a subcontractor to California Northern Railroad
February 2008

ATTACHMENT II

REPORT CONTENTS

AUDIT REPORT – Quality Signal Construction, a subcontractor of California Northern Railroad

	<u>Page</u>
Summary	1
Background	2
Conclusion	3
FINDINGS AND RECOMMENDATIONS	
1. Inadequate Financial Management System	4
2. Unsupported Direct Labor Costs	5
3. Unsupported Fringe Benefit and Overhead Costs	6
4. Unsupported Other Direct Costs	7
5. Unsupported Equipment Costs	8
6. Unsupported Fee	10

ATTACHMENT

IIA. Response of Quality Signal Construction

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

SUMMARY

We have audited the costs claimed by the Quality Signal Construction (QSC), a maintenance subcontractor to California Northern Railroad (CNR), totaling \$5,778,572, for work performed pursuant to Agreement No. 50R981 (Agreement) between the Department of Transportation (Department) and CNR. CNR reimbursed QSC \$4,610,000 of the total costs claimed. The audit was performed to determine whether costs are adequately supported and in compliance with the Agreement provisions and State and federal regulations. We also audited QSC's financial management system to determine whether it is adequate to accumulate and segregate reasonable, allocable, and allowable costs. This audit is performed as a management service to the Department to assist in its fiduciary responsibility to State and federal regulatory agencies.

QSC is responsible for the claimed costs, compliance with Agreement provisions and State and federal regulations, and the adequacy of its financial management system to accumulate and segregate reasonable, allocable, and allowable costs.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit was less in scope than an audit performed for the purpose of expressing an opinion on the financial statements of QSC. Therefore, we did not audit and are not expressing an opinion on QSC's financial statements.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records selected. An audit also includes assessing the accounting principles used and significant estimates made by CNR, as well as evaluating the overall presentation.

The scope of the audit was limited to financial and compliance activities related to the above-referenced Agreement. The audit consisted of tests of transactions supporting costs totaling \$5,778,572, claimed by QSC in a "Recap of QSC contract Costs" provided to the auditor at the beginning of the audit, as well as an evaluation of compliance with 23 Code of Federal Regulations (CFR), 140 and 646. We interviewed applicable personnel to obtain an understanding of QSC's financial management system as of August 31, 2006. Financial management system changes and transactions arising subsequent to this date were not tested and, accordingly, our conclusion does not pertain to costs or credits arising after this date.

Due to inherent limitations in any financial management system, misstatements caused by error or fraud may occur and not be detected. Also, projections of any audit of the financial management system to future periods are subject to the risk that the financial management

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

system may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our findings and recommendations take into consideration QSC's response dated November 16, 2007, to our June 28, 2007, draft report. Our findings and recommendations, QSC's response, and our analysis of the response are set forth in the Findings and Recommendations to this report. A copy of QSC's full response is included as Attachment IIA.

BACKGROUND

On February 19, 2002, the Department entered into an Agreement with CNR for the elimination of hazards at 14 Railroad-Highway crossings in the City of Woodland. Subsequently, CNR contracted with subcontractor, QSC, to perform the work.

The Agreement between the Department and CNR required CNR to perform the work on a force account basis, whether the work was performed by CNR or a subcontractor. CNR failed to contractually place that requirement on QSC who bid the work on what appears to be a lump sum method of payment.

The Department's Division of Rail (Rail) requested that Audits and Investigations (A&I) perform an incurred cost audit of the Agreement with CNR. A&I began the incurred cost audit of CNR in August 2004. Since the majority of the costs reimbursed to CNR were incurred by QSC it was determined that an incurred cost audit of QSC was necessary. On September 22, 2004, a meeting was held between CNR, QSC, Rail and A&I to discuss the incurred cost audit of CNR and QSC. It was disclosed that QSC did not maintain an accounting system to substantiate billings on a force account basis. QSC agreed to undergo the audit but informed A&I that they needed time to compile their accounting records. Over the course of the audit, QSC attempted to substantiate the claimed costs and requested numerous extensions of time to locate records. The completion of the audit was delayed due to granting QSC additional time.

CONCLUSION


Based on our audit, costs claimed, totaling \$5,778,572, were not adequately supported and in compliance with the Agreement provisions and State and federal regulations. In addition, QSC's financial management system was not adequate to accumulate and segregate reasonable, allowable, and allocable project costs. As a result, \$4,610,000, which represents the amount CNR paid to QSC under the Agreement, are unallowable. (See findings and recommendations for detail.)

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

This report is intended for the information of the Department, the Federal Highway Administration, the California Transportation Commission, CNR, and QSC. However, this report is a matter of public record and its distribution is not limited.

If you have any questions, please contact Luisa Ruvalcaba, Auditor, at (916) 323-7888 or Teresa Greisen, Audit Manager, at (916) 323-7910.



MARYANN CAMPBELL-SMITH
Chief, External Audits

Attachment

Audit Team

Teresa Greisen, Audit Manager
Zilan Chen, Audit Supervisor
Luisa Ruvalcaba, Auditor

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

FINDINGS AND RECOMMENDATIONS

Finding 1 – Inadequate Financial Management System

Based upon our audit, Quality Signal Construction (QSC) does not have a financial management system that is adequate to accumulate and segregate reasonable, allocable, and allowable project costs. As a result, QSC could not ensure that costs charged to California Northern Railroad (CNR), and ultimately to the Department, were properly attributable to the Agreement project.

Specifically, we noted:

- QSC lacked an adequate timekeeping and labor distribution system and, therefore, was unable to properly substantiate the claimed direct labor costs pertaining to the Agreement under audit. (See Finding 2 below.)
- QSC failed to identify other direct costs as project costs relating to the Agreement under audit. (See Finding 4 below.)
- QSC did not have a system in place to track or summarize its equipment costs. (See Finding 5 below.)

In addition, we noted that \$193,259 of the \$5,778,572 costs claimed by QSC incurred either prior to the Agreement start date or after the Agreement end date. Since the costs were incurred outside the Agreement period, costs are unallowable and should not have been claimed.

23 CFR 140.904(b) Eligibility, states: "To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, B
- (4) Properly attributable to the project."

Recommendation:

We recommend that the total claimed costs of \$4,610,000 incurred by QSC be disallowed. In addition, QSC should implement a financial management system that adequately accumulates and segregates reasonable, allocable, and allowable project costs.

QSC Response:

QSC disagrees with the finding and recommendation. See Attachment "IIA".

Auditor's Analysis of QSC Response:

QSC did not provide additional documentation therefore the finding remains.

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

Finding 2 – Unsupported Direct Labor Costs

Based upon our audit, QSC could not properly substantiate \$515,684 in claimed direct labor costs. Specifically, our audit noted:

- During testing, it was noted that none of the claimed labor hours were coded to a specific project number. Instead, the claimed hours were identified in the timesheets to street names, city name “Woodland,” “shop,” or no identification at all. Some of the street names agree with street names identified in the Agreement between the Department and CNR. QSC stated that the claimed hours were for the grade crossing construction project; therefore, we have no assurance that the claimed hours were for the project under audit, rather than work for other projects. In addition, QSC did have a maintenance contract with CNR in the Woodland area and claimed that one person was assigned to perform all maintenance work. However, QSC did not provide evidence to corroborate this testimonial claim.
- In order to support that construction work performed was for the Agreement under audit, QSC provided ten Construction Daily Reports (CDRs), with direct labor costs, totaling \$5,257. However, the CDRs provided did not specify the hours worked, used nick names or first names of employees, and lacked corroborating information (work location, work hours, etc.) to tie to employee timesheets. Therefore, we were unable to rely on the CDRs as support for the direct labor costs billed.
- A number of timesheets/pay registers requested were missing; some timesheets stated only total hours worked without an identifier as to where the work was performed or for what project. Additionally, incorrect labor rates were used. These factors resulted in 21% of direct labor costs tested to be unallowable, which amounted to \$69,362.
- The claimed direct labor included direct labor hours pertaining to QSC owners. However, the owners did not maintain timesheets and the owners’ Daily Dairies were not located. Therefore, QSC was unable to substantiate the owners’ direct labor time and the claimed costs pertaining to the owner’s time in the amount of \$185,388 is not allowable.

23 CFR 140.904(b) Eligibility, states: “To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, subpart B.
- (4) Properly attributable to the project.”

Recommendation:

We recommend \$515,684 of the \$5,778,572 in total claimed costs be disallowed. The disallowed direct labor costs are already included in Finding 1 above.

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

QSC Response:

QSC disagrees with the finding and recommendation. See Attachment "IIA".

Auditor's Analysis of QSC Response:

QSC did not provide additional documentation therefore the finding remains.

Finding 3 – Unsupported Fringe Benefit and Overhead Costs

Based upon our audit, QSC could not properly substantiate \$891,981 in claimed Fringe Benefit and Overhead costs. Specifically, our audit noted QSC's general ledger breaks the accounts down into various subcategories - California Construction, California Maintenance, and Overhead. We traced the fringe benefit/overhead rate schedules to the general ledger and noted substantial variances. In some cases, the account total, pursuant to the schedules, was greater than the total of the three subcategories combined. No further work was performed in this area, given the audit issues noted in Finding 1 and 2 above.

23 CFR 140.904(b) Eligibility, states: "To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, subpart B.
- (4) Properly attributable to the project."

Recommendation:

We recommend that \$891,981 of the \$5,778,572 in total claimed costs be disallowed. The disallowed fringe benefit and overhead costs are already included in Finding 1 above.

QSC Response:

QSC disagrees with the finding and recommendation. See Attachment "IIA".

Auditor's Analysis of QSC Response:

QSC did not provide additional documentation therefore the finding remains.

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

Finding 4 – Unsupported Other Direct Costs

Based upon our audit, QSC could not properly substantiate \$3,353,509 in claimed other direct costs. Specifically, our audit noted:

- \$1,009,819 in subcontractor costs, \$1,812,801 in materials costs, \$269,561 in other direct costs, and \$30,196 in freight are disallowed due to the lack of a proper financial management system and proper coding on corresponding vendor invoices that could directly relate the vendor invoice to the project under audit. When the audit started, QSC identified Agreement project costs by going through all its vendor invoices; and if a vendor invoice was determined to be a project cost based on any known information from the QSC Accountant, Project Manager or Owners, then a copy of the invoice was included in a pre-established binder based on invoice date. A binder had previously been established per calendar year for the purpose of substantiating the project costs. A listing was then made per year that identified the invoices considered as project costs included in each binder. The listing included the invoice date, vendor name, type of cost (subcontractor, material, other direct costs or freight) and amount. Those yearly lists were then compiled into one list to determine the total amount that QSC claimed as Subcontractors, Materials, Other Direct Costs, and Freight.

An audit sample was selected from the listing to trace to the original vendor invoice and for payment verification. However, it was noted that most of the vendor invoices tested had no direct reference to the project. QSC did provide some vendor invoices that included reference to "Woodland" or to street names. Some of these street names are the same as the name listed on the Agreement between the Department/CNR and QSC's cost-estimate documents to CNR, but copies of contract agreements between QSC and its subcontractors were not provided to corroborate that the work performed was for the project under audit. Given that QSC did not have a financial management system in place to track job costs and that contract agreements for subcontractors were not provided, it could not be verified that the vendor invoices are directly attributable to the Agreement project.

Also, as noted in Finding 2 above, QSC provided ten Construction Daily Reports (CDRs) to substantiate that construction work performed was directly related to the Agreement project. However, while the CDRs listed the material used on the work performed that day, they did not identify the corresponding cost of the material.

- \$140,492 in total taxes paid by QSC to the State Board of Equalization for various costs claimed on the project are disallowed since the other direct costs on which the taxes are based cannot be directly attributed to the Agreement project.

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

- \$90,640 in claimed material handling costs, representing 5% of the total claimed material costs, are disallowed since the material costs on which the handling cost is based cannot be directly attributed to the Agreement project.

23 CFR 140.904(b) Eligibility, states: "To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, subpart B.
- (4) Properly attributable to the project."

Recommendation:

We recommend that \$3,353,509 of the \$5,778,572 in total claimed costs be disallowed. The disallowed other direct costs are already included in Finding 1 above.

QSC Response:

QSC disagrees with the finding and recommendation. See Attachment "IIA".

Auditor's Analysis of QSC Response:

QSC did not provide additional documentation therefore the finding remains.

Finding 5 – Unsupported Equipment Costs

Based upon our audit, QSC could not properly substantiate \$263,671 in claimed equipment costs. Specifically our audit noted:

- When the audit started, QSC did not have a method of tracking or summarizing their equipment costs. Therefore, in order to substantiate its claimed equipment costs, QSC prepared Daily Reports (DR) that summarized direct labor and equipment incurred per day. The DRs were created by reviewing the employee's timesheets and summarizing direct labor posted for all employees each day. Based on the created DRs, QSC then determined what equipment it believed the employees had used each day. The DRs were then compiled by month as direct labor or equipment costs. Equipment costs were calculated using the Department's Labor Surcharge and Equipment Rental Rates (LS&ERR).

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

Based upon our audit tests of the DRs, we noted QSC applied the regular time rate to all claimed labor hours (regular and overtime). However, the LS&ERR, effective April 1, 2002, through March 31, 2003, identifies a lower rate for overtime on some of the claimed equipment. As a result, we noted a variance of 2.9% (\$1,561) on the equipment costs due to QSC applying the regular time rate to all claimed hours (regular and overtime).

- QSC was unable to adequately support the claimed direct labor hours. (See Finding 2 above.) Since the direct labor hours are unsupported, then the related equipment costs are unsupported as they are based solely on the employee's time listed on the DRs.

Also, as noted in Finding 2 above, QSC provided ten Construction Daily Reports (CDRs) to substantiate that construction work performed was directly related to the Agreement project. However, while the CDRs listed the type of equipment used on the work performed that day, they did not identify the corresponding cost of the equipment.

- QSC did not provide adequate documentation to establish whether all the equipment charged per day was, in fact, the type of equipment actually required for the work performed. In addition, QSC lacked adequate documentation to support the hours charged for equipment usage (all hours corresponded exactly to the hours charged by employees for the day). These two concerns are raised due to the fact that the DRs were created after the audit started, and there is no way to verify that, in fact, all claimed equipment was actually used and used for the exact number of hours charged on the employees' timesheets.

23 CFR140.904(b) Eligibility, states: "To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, subpart B.
- (4) Properly attributable to the project."

Recommendation:

We recommend that \$263,671 of the \$5,778,572 in total claimed costs be disallowed. The disallowed equipment costs are already included in Finding 1 above.

QSC Response:

QSC disagrees with the finding and recommendation. See Attachment "IIA".

ATTACHMENT II

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

Auditor's Analysis of QSC Response:

QSC did not provide additional documentation therefore the finding remains.

Finding 6 – Unsupported Fee

Based upon our audit, QSC could not properly substantiate \$753,727 in claimed fee costs. Specifically, our audit noted:

- There is no contract specifying the fee to be paid to QSC for the work performed.
- The Agreement between the Department and CNR was based on actual cost. Therefore, no fee is allowed.
- Since all other costs claimed by QSC are unallowable, the fee cannot be claimed.

23 CFR 140.904(b) Eligibility, states: "To be eligible, the costs must be:

- (1) For work which is included in an approved statewide transportation improvement program.
- (2) Incurred subsequent to the date of authorization by the Federal Highway Administration.
- (3) Incurred in accordance with the provisions of 23 CFR, Part 646, subpart B.
- (4) Properly attributable to the project."

Recommendation:

We recommend that \$753,727 of the \$5,778,572 in total claimed costs be disallowed. The disallowed fee is already included in Finding 1 above.

QSC Response:

QSC disagrees with the finding and recommendation. See Attachment "IIA".

Auditor's Analysis of QSC Response:

QSC did not provide additional documentation therefore the finding remains.

ATTACHMENT IIA

INCURRED COST AUDIT OF QUALITY SIGNAL CONSTRUCTION

Response of Quality Signal Construction



Lewis C. Miltenberger

817-251-4500 ext 107

lmiltenberger@miltengerdettmer.com

November 16, 2007

MARYANN CAMPBELL-SMITH

State of California
Department of Transportation
Chief, External Audits
Audits and Investigations
1304 O Street, Suite 200
P.O. Box 942874 (MS2)
Sacramento, CA 94274-001

VIA EMAIL: MaryAnn.Campbell-Smith@dot.ca.gov

Re: Quality Signal Construction, Inc.'s Response to Incurred Cost Draft Audit Report

File No. P1130-0774
Agreement No. 50R981
Project No. STPLR-5046(022)

Dear Ms. Campbell-Smith:

As you know, this firm was recently retained by Quality Signal Construction, Inc. ("QSC") with regard to the Draft Incurred Cost Audit. On October 24, 2007, on behalf of QSC, we requested a ninety-day extension of time to respond to the Draft Incurred Cost Audit. On October 26, 2007, you extended QSC's time to respond fifteen (15) days to November 16, 2007. Although the extension was greatly appreciated, it was not, practically speaking, enough time to provide a full and complete response to the Draft Incurred Cost Audit Report. However, in the spirit of cooperation, we have attempted to clarify and summarize QSC's position with regard to the audit and the recommendations provided in the draft.

The Department initiated a field audit of California Northern Railroad ("CNR") on or about August 19, 2004. On or about October 6, 2004, the Department notified QSC, that it, too, would be the subject of field audit with regard to this project. A draft audit report was issued on or about June 28, 2007. The draft audit listed a number of findings and recommendations with regard to the financial management and compliance activities related to the project. As detailed in the draft audit report, CNR failed to pass on certain contractual obligations imposed on it by CALTRANS (the "Department") including, among other things, requirements to maintain records on a force account basis and requirements to maintain records for a period of three years, to its sub-contractor, QSC.

As a result of this and other findings, this law firm was retained to coordinate a mass search and review of documents for a project that was completed more than two years ago and for which construction began sometime in 2002. It was evident from the beginning of this undertaking that to properly and completely reconstruct accounting records of the cost incurred,

1130 N. Carroll Avenue, Suite 100 • Southlake, Texas 76092
Telephone (817) 251-4500 • Facsimile (817) 251-4544
www.miltengerdettmer.com

and to properly attribute them to the project, a time consuming and costly forensic accounting of the existing records would have to be undertaken. Such a project would necessarily include other vendors and subcontractors and would likely require thousands of man-hours to complete. Given the caveat that such a project has not been undertaken, we have done our best to respond timely to the Incurred Cost Draft Audit Report based on the information gathered to date.

It is not immediately apparent under what authority, contractual or otherwise, the Department is performing the referenced audit of the records of Quality Signal Construction, Inc., as a sub-contractor of CNR. Notwithstanding, and as a matter of good faith, QSC has fully participated in the audit process.

It is undisputed that QSC was under no contractual obligation to maintain accounting records in the same manner that CNR was contractually obligated to do so. Although a reciprocal requirement would have facilitated a complete, more efficient response to the audit, no such requirement existed. As the draft audit points out, the "on-going" contract between QSC and CNR required only written approval of materials and design:

New Construction. It is agreed that during the term of this Agreement QSC will solicit crossing upgrades and new installation on behalf of Railroad, and will layout, supply, and install crossings only after Railroad written approval of materials and design. Any projects that have been approved, whether funded or not, at the conclusion of this agreement will be completed by QSC. Railroad retains the right to solicit bids from other contractors for construction of crossings if QSC fails to meet Railroad's standards of quality and safety, or CPUC standards for new construction.

Further, pursuant to the agreement negotiated between QSC and CNR, QSC was exposed to several inherent risks, including, but not limited to, funding risk and "standard of quality" risk which potentially could have resulted in its termination as the sub-contractor of the project. The contract was negotiated in good faith and exposed both parties to risk, both known and unknown. However, there was no agreement between the parties to provide the work on a "force account" basis. QSC may well have entered into such an agreement, but other contract terms may have had to change, as well.

While there may be some legitimate questions and criticisms with regard to accounting system management, documentation and record keeping, as a result of CNR's failure to pass on contract obligations, there is, to our knowledge, no evidence or allegation of inappropriate expenditures or cost overruns suggested by the draft audit. In addition, and more importantly, there has not been one negative comment by the Department, CNR, or any other governing entity, with regard to a matter of public safety or that CPUC standards were not met by QSC. Finally, there has not been a single mention by the Department, CNR or any governing entity with regard to the dissatisfaction of the quality of the workmanship or the product provided by QSC. In short, QSC provided what it was contractually required to provide and did so within the terms of the agreement to which it was a party.

The objective of our response is to provide assistance and cooperation to the Department and CNR to both document the reasonableness of charges on the Project and illustrate measures taken to ensure that problems do not occur in the future. Given a realistic time frame and an agreement to cover necessary expenditures, QSC will attempt to provide credible, reliable back-up documentation for proper expenditures on Project No. STPLR-5046 (022). In furtherance of its participation and because QSC was referenced directly in the draft audit report, QSC provides the following response to the Incurred Cost Draft Audit Report.

While QSC does agree with some of the recommendations in the draft audit, it does not fully agree with the findings for some individual items. Summarily, QSC disagrees with the auditor's findings regarding QSC's alleged responsibility for claimed costs and compliance with the agreement between the Department and CNR, as detailed in Attachment II of the draft report. The following provides a brief overview of the transaction and addresses each of the Department's findings.

Overview

QSC did not seek reimbursement from CNR or the Department for charges incurred. Rather, QSC performed all construction services for CNR under an existing maintenance agreement ("Maintenance Agreement") between the parties. Pursuant to the Maintenance Agreement, QSC was to "layout, supply, and install crossings only after Railroad written approval of materials and design." Accordingly, on September 20, 2001, QSC provided CNR with lump sum estimates identifying the scope of work, materials and surface work to be completed for each of the fourteen (14) crossings included in the Woodland Corridor Project (the "Project"). CNR reviewed and forwarded the approved estimates to the Department, adding a five percent (5%) "CFNR project fee" to each estimate.¹ At some point thereafter, CNR and the Department entered into a Service Agreement (50R981). QSC commenced installation of the grade-crossing safety devices only after a Notice to Proceed was received from CNR. An additional agreement for the installation of the Woodland Corridor grade-crossings was not required.

Likewise, the billing process followed the same pattern. Once the work was completed, progress billings (lump sum) would be sent to CNR, and, subsequently to the Department and additional entities. The FHWA or state agency would approve the invoices and issue payment. No greater detail was ever required or even requested. The cost for this project is well within estimated cost of a project with this scope and complexity. In fact, the retainage of some \$308,448 was recently released by the State, evidencing that the project was completed to specifications.

The above-described process is consistent with QSC's experience and past practices involving other federally funded projects in the State of California at that time.

Audit Process

From the beginning of the audit process, QSC has cooperated with the auditors while maintaining that the Woodland Corridor Project was bid, invoiced, approved and, thus, documented on a lump sum basis. As a result, QSC indicated that it may not be able to provide all requested documentation. The documentation initially provided by QSC, including the "Recap of QSC contract Costs" was apparently the attempt of a former employee² of QSC to summarize and provide estimates of the cost of the project on a force account basis, albeit after the fact. While our subsequent review of the documentation confirms that such information was in summary/estimate form, it also has revealed source documents substantiating costs incurred on the Project. Such documents have not been provided to the Department to date.

¹ The nature of this project fee—approximately \$187,000—is unknown to QSC.

² QSC's then senior accountant was in charge of responding to the requests for information concerning the audit.

As the contract between CNR and QSC neither required QSC to maintain accounting records, which document that costs incurred were attributable to the project, nor required that such records be maintained and subject to audit for three years, there is significant time and costs associated with any further review of supporting documentation, some of which may or may not have been transported when QSC moved its headquarters to Texas. We believe, based on the source documents discovered thus far, that QSC can provide source documentation of costs incurred. However, QSC has expended considerable time and incurred significant costs thus far in searching for documents for which it was neither required to maintain or make available for inspection. Absent authority of the Department to compel its further cooperation, QSC is willing to further cooperate in the audit process only if the Department and/or CNR agree to reimburse it for the costs involved.

Specific Findings

Finding 1—Inadequate Financial Management System

QSC disagrees with both the conclusions drawn and the recommendation that all costs be disallowed. The Department believes, and QSC agrees, that CNR did not contractually obligate QSC to maintain necessary records to efficiently, properly and thoroughly reply to the draft audit or to account for expenditures on a force account basis. Any requirements to ensure that costs charged to CNR were properly attributable to the project, imposed on CNR by the Department as a condition to reimbursement, were not so imposed on QSC.

Beginning in the early part of 2002, QSC operated a job costing accounting system which captured costs associated with the above-referenced project. This job costing system provides the detail necessary to accumulate and segregate reasonable, allocable, and allowable project costs. QSC's implementation of the system during the project period, however, appears less than perfect due to several factors: (1) the system was new³ and more complex than its previous accounting system; (2) the Woodland Project was bid on a lump sum basis and QSC did not require the level of separation and detail of charges for its own internal accounting; and (3) management and staff turnover within QSC's accounting department during the period.

The Project was assigned a project number to which labor, subcontractor, materials and equipment costs were assigned. The job cost ledger associated with the project number for the Project indicates that the majority of the costs incurred were captured by the system. QSC's job costing accounting system captured direct labor, material, subcontractor and equipment rental costs attributable to the project. During our review, however, we discovered certain costs attributable to the project⁴ were not captured by the system and, thus, not represented on the job cost ledger. Although our review is incomplete at this time, we have located source documents supporting costs captured by the job cost ledger, and evidencing attributable costs not so captured. We are unclear as to why the job cost ledger and supporting documents were not provided to the Department initially. It is likely this resulted from the move to Texas and the internal turnover within the accounting department, however.

Given the findings and recommendations listed in the draft audit, a brief description of changes already implemented at QSC seem appropriate and are addressed below, along with a

³ QSC transitioned from a simple accounting system to a more comprehensive one in February 2002.

⁴ Indirect costs, costs associated with the use of QSC owned equipment, materials and subcontractor costs for signal work and labor costs associated with the owner's time were not captured by the job costing system.

historical description of the financial management and accounting procedures within the company:

Since the beginning of the construction of the project in question, QSC has undergone major changes. A key individual with responsibilities of financial management and procedures left the company. Upon his departure, the remaining members of management entrusted most of the duties related to the company's finance and accounting systems to the company's senior accountant. In hind sight, it may have been that the individual charged with these duties was not up to the task but, unfortunately, the individual may have been able to hide that fact for some time.

By early 2006 the volume of business that QSC was performing in Texas had grown to the point that management felt it appropriate to relocate the company offices to Fort Worth. In the months leading up to the move, QSC management began having concerns about deficiencies in their accounting department and after the re-location to Texas put together a much more experienced accounting staff than was in place in California. A very seasoned controller was hired to lead the new accounting department. Management immediately put in motion a program aimed to identify all open issues and to develop a plan to correct them. This task was delayed when the new controller was forced to resign unexpectedly for health reasons. It was at that point that QSC management determined it was necessary for outside consultants to become actively involved in the financial management of the company. QSC has implemented policies and procedures to make its financial management tools more effective. Unfortunately, the systems in place today can only assist in providing answers for yesterday's issue. However, with the implementation of the policies and procedures, future financial and accounting issues should be kept to the bear minimum.

On the conditions referenced above, QSC will attempt to locate additional source documents necessary to update the job cost ledger such that it will evidence a comprehensive review of charges attributable to the project. Due to the time and cost required to document such charges to CNR, QSC was not able to provide such information as of the filing of this response.

Finding 2—Direct Labor Costs

QSC disagrees with both the conclusions drawn and the recommendation that all costs be disallowed. Again, QSC was not required to maintain accounting records on a force account basis. As mentioned above, however, direct labor costs for construction were coded to a specific job and attributed to the project.

We have located original time sheets, payroll records and other source documents not previously provided to the Department that support the costs shown in job costing system. These original documents also substantiate that no labor costs for maintenance were coded to the project. At this time, it appears that the labor spent by the owners is not supported by time sheets. Practically speaking, however, the time spent by the owners directly working on the project, if not represented as a direct labor charge, would be allocated in the overhead calculations, which at this point have not been derived, as QSC documented on a lump sum basis.

On the conditions stated above, QSC is willing to search for additional source documents to substantiate the labor charges associated with the owner's time and any other uncaptured labor charges, as well as provide applicable documents located to date, not previously provided to the Department. Due to the time and cost required to document such charges to CNR, we were not able to provide such information as of the filing of this response.

Finding 3—Unsupported Fringe Benefit and Overhead Costs

QSC disagrees with both the conclusions drawn and the recommendation that all costs be disallowed. Again, QSC was not required to maintain accounting records on a force account basis. As stated above, the information previously provided to the Department was apparently an attempt by a former employee to estimate the costs on a force account or time and materials basis after the fact. Notwithstanding, as overhead is a function of costs, as defined by FAR regulations, QSC will calculate its overhead cost for each year of the project once all attributable costs have been completely identified. Due to the time and cost required to document such charges to CNR, QSC was not able to provide such information as of the filing of this response.

Finding 4—Unsupported Other Direct Costs

QSC disagrees with both the conclusions drawn and the recommendation that all costs be disallowed. Again, QSC was not contractually or otherwise required to maintain accounting records documenting that the materials purchased by QSC, labor expended by QSC and equipment utilized by QSC were directly attributable to the agreement Project. As discussed above, QSC operated a job costing accounting system which captured costs associated with the crossing project. The job costing accounting system captured material, subcontractor and equipment rental costs attributable to the project, but failed to capture certain other costs attributable to the project.

As mentioned previously, we have located several source documents supporting those costs captured by the system, as well as evidencing attributable costs not so captured. As QSC was not required to maintain records on a force account basis, certain source documents from vendors and subcontractors do not contain a direct reference to the project. Although such charges are attributable to the project, the allocation will have to be evidenced through other documents, a search for which would involve the cooperation of third parties and significant time and cost.

On the conditions referenced above, QSC will attempt to locate additional source documents necessary to update the job cost ledger such that it will evidence a comprehensive review of charges attributable to the project. Due to the time and cost required to document such charges to CNR, QSC was not able to provide such information as of the filing of this response.

Finding 5—Unsupported Equipment Costs

QSC disagrees with both the conclusions drawn and the recommendation that all costs be disallowed. Again, QSC was not required to maintain accounting records on a force account basis. As mentioned above, equipment charges for QSC owned equipment were not captured by the job costing system and, thus, are not represented on the job cost ledger. Our limited review reveals that source documents, which indicate the equipment used on the Project, are available. To what extent, however, is unknown at this time. Based on documents gathered to date, we believe that additional construction daily reports, fixed asset records, vehicle registration records, among other documents substantiate what vehicles were owned and used on the Project. At that point, determining the cost will simply involve applying the applicable Blue Book rate. However, such will involve a significant amount of time and money.

On the conditions referenced above, QSC will attempt to locate additional source documents necessary to update the job cost ledger such that it will evidence a comprehensive

review of charges attributable to the project. Due to the time and cost required to document such charges to CNR, QSC was not able to provide such information as of the filing of this response.

Finding 6—Unsupported Fee

QSC disagrees with both the conclusions drawn and the recommendation that all costs be disallowed. Again, QSC was not required to maintain accounting records on a force account basis. As stated above, the Recap of QSC Construction Costs was apparently created to estimate and break down the costs incurred as if on a force account basis. The Fee listed therein represents an estimate of profit if the Project would have been bid and performed on such basis. It is apparent that once the costs discussed herein are set, the fee or profit attributed to the Project, if any, will be reasonable and fixed. Due to the time and cost required to document such charges to CNR, QSC was not able to provide such information as of the filing of this response.


Conclusion

As discussed in detail above, we believe, given a realistic time frame, QSC will be able to provide a comprehensive review of charges attributable to the Project through an updated job cost ledger that is supported by credible, reliable source documentation. We further believe that once such is in place, the reasonableness of such charges will be evident to the Department. The actions taken or planned by QSC are responsive to the audit recommendations. With these actions, QSC can better control accounting procedures and document retention policies and assure they are put to their best possible use in complying with governmental or contractual requirements.

As a final matter, QSC is capable of and does maintain records on a force account basis when required to do so pursuant to a contract with a particular railroad. All of the issues involved with this audit could have been avoided had CNR passed on the requirements imposed on it by the Department.

If you have any questions regarding this response, please contact me directly at the number above.

Respectfully Submitted,


Lewis C. Mittenberger

cc: Clyde Hutchinson, Esq., via facsimile and email